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SENSITIVE

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TREASURY FOR OIA VIMAL ATUKORALA

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SUBJECT: Italy Implements Measure to Bolster Bank-Lending.

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¶1. (SBU) Summary -- On February 26, the GOI authorized the Italian Treasury to buy extraordinary convertible bonds issued by Italian banks as a way to raise banks' capital ratios and spur new lending, especially to small and medium businesses. The instruments, in terms of risks taken by the GOI and Banks' obligations, are closer to shares than bonds, and as such will count in Tier 1 capitalization ratios. Conditions for banks to issue such bonds include allowing the government to monitor bank lending, providing mortgage relief to certain borrowers, limiting executive compensation, and refraining from paying dividends. Banks deny there is a credit crunch in Italy, but might, for political and appearances' sake, participate to a limited extent in the program. The GOI's measure appears consistent with other major economies' efforts to revive lethargic credit markets. End Summary

¶2. (U) On February 26, Economy Minister Giulio Tremonti signed a decree allowing the Italian Treasury to buy extraordinary convertible bonds issued by Italian banks. The so-called Tremonti Bonds are special financial instruments convertible to equity shares, and as such, contribute to Tier 1 capital. While bearing an annual yield of between 7.5% and 8.5%, the bonds' face value will vary with banks' capitalization ratios; if bank capital grows, so will the bonds' face value. If bank capital falls, bonds' face value will fall. The bond measure, which the government had outlined in November 2008 as part of its general stimulus package (reftel), was prompted by a GOI concern that the economic slowdown has driven banks to cut back lending, especially to small and medium businesses, thus exacerbating the recession in Italy.

¶3. (U) In order to prevent these funds to simply bolster bank balance sheets with no positive impact on the "real" economy, the government conditioned issuance of the bonds on a broad agreement between Italy's banking association and the Ministry of Economy and Finance. The proposed agreement would require banks to keep up loans to small- and medium-sized firms and households, to provide mortgage relief to people receiving unemployment benefits or on part-time layoffs, to limit salaries and bonuses for bank management, and to commit not to distribute dividends to shareholders. Most remarkably, participating banks would have to agree to a government-appointed banking "prefect" to monitor their loans for socioeconomic merit. Before approving any bond issue, the Bank of Italy will review each applicant bank's capital structure and risk profile.

¶4. (U) Tremonti in November outlined the program ranging from 10 to 12 billion. The government intends to finance it with a mix of modest spending cuts, re-directing unspent funds of public institutions and issuing new government securities that supposedly will have a limited or negligible impact on public debt or the deficit.

¶5. (SBU) Banks contend that they have little need for these

securities and that there is no credit or liquidity crunch in Italy.

Any slowdown in credit flows, they maintain, is due to dropping demand for loans (one Milan bank told econoff that of euro 500 billion in credit lines outstanding, clients have used only 370 billion). While this may be technically true, small and medium firms complain that the reason for the drop-off in demand is that interest rates remain too high. Indeed, Italian banks have maintained the fat 400 basis-point margin between cost of funds and average loan rates that they enjoyed prior to the October 2008 meltdown. Italian banks fund themselves approximately one third from checking accounts (whose average interest rate is 0.5%), one third through the interbank market (at rates ranging from 1.7-1.8%), and the remaining third from bonds. Moreover, one fifth of Italy's gross national income is saved every year, a rate that is among the highest in any advanced economy, equal to about 10% of disposable income. This means banks have a huge flow of funds available at very modest interest cost, averaging just under two percent.

¶6. (SBU) Comment: The measure seems designed, like earlier ones, to bolster the Italian public's confidence in the banking system, while at the same time demonstrating the Italian government's will to compel the financial sector to throw in its lot with ordinary Italians struggling to overcome the recession. In addition, the terms of the bonds seem designed to entice other private institutions to invest in banks (a provision requires that 30% of the bond issue be subscribed by private entities). So far, the government can point to just one un-named bank (very likely the Banco Popolare network) coming forward to take part in the plan. Italy's largest banks (Unicredit, Intesa-San Paolo, Monte dei Paschi di Siena (MPS), Banco Popolare and UBI Banca) have not yet announced their intentions, but press commentators speculate that Unicredit and Intesa San Paolo may request 3 billion each, while MPS could

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apply for 1.5 billion. Whether Banks will participate and to what extent will probably depend more on banks' perceived need to be seen to collaborate with the government, than on actual weakness in their capital structure. What will likely give banks the greatest pause is the notion of having yet another government overseer second-guessing their decisions and possibly pressing them into imprudent loans. Individual banks could announce their intentions by week's end.

Dibble